Supreme Court, U.S.
FILED
JUN 2 1999
CLERK

(3)

No. 98-1639

In The

Supreme Court of the United States

SUSAN TAYLOR MARTIN,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

R. Lee Eddy, III*
433 Metairie Road, Suite 100
Metairie, Louisiana 70005
(504) 835-0378

Frank J. Romaguera IV
Suite 1130
3850 North Causeway Boulevard
Metairie, Louisiana 70002
(504) 830-2929

Counsel for Petitioner

**Counsel of Record*

June 1, 1999

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

13PP

PARTIES TO THE PROCEEDINGS

All parties to the proceedings in the United States Court of Appeals for the Fifth Circuit are listed in the caption: petitioner, Susan Taylor Martin, plaintiff-appellant below, and respondent the United States of America, defendant-appellee below.

TABLE OF CONTENTS

Page

PARTIES TO THE PROCEEDINGS i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iii

INTRODUCTION 1

ARGUMENT 3

1. Respondent's strict construction ignores the substance of the transaction, inflicts a palpably arbitrary and patently unequal treatment upon one of two equal and identically situated co-owners of community property, and affects a significant number of community property owning spouses 3

2. The "origin of the claim doctrine" requires that the Tenneco payment to Susan be afforded the benefit of the IRC Section 1398(f)(2) tax exclusion 5

3. A failure to treat Susan as a debtor for purposes of conferring the benefit of the tax exclusion under IRC Section 1398(f)(2) denies her equal protection of the laws as guaranteed by the Fifth and Fourteenth Amendments of the United States Constitution. When considering the situation, circumstance and factual context of the non-filing spouse in community, the claimed distinctions of "debtor" and "creditor" are not relevant and are not material 7

CONCLUSION 9

TABLE OF AUTHORITIES

Page

CASES:

Califano v. Boles, 443 U.S. 282, 99 S.Ct. 2767 (1979) 9

Hampton v. Mow Sun Wong, 426 U.S. 88, 96 S. Ct. 1895 (1976) 9

Lyeth v. Hoey, 305 U.S. 188, 59 S. Ct. 155 (1938) 6

CONSTITUTIONAL PROVISIONS AND STATUTES:

U.S. Const. amend. V 7, 8, 9

U.S. Const. amend. XIV 7, 9

11 U.S.C. § 541 3

11 U.S.C. § 541(a)(1) 3

11 U.S.C. § 541(a)(2) ..... *passim*

11 U.S.C. § 726 ..... 2, 3, 4, 6, 8

11 U.S.C. § 726(c)(2)(A)-(D) 1

26 U.S.C. § 1398(f) 1, 5

26 U.S.C. § 1398(f)(2) 2, 5, 7, 9, 10

26 U.S.C. § 7701(45) 4

La. Civil Code Article 2336 8

OTHER AUTHORITIES:

The Wall Street Journal, May 6, 1999, "House approves bankruptcy overhaul amid criticism bill may be too tough." Section A, Page 28, 5th Paragraph. Schlessinger, Jacob M. 4

INTRODUCTION

Bankruptcy Code Section 541(a)(2) makes "all interests of the debtor and the debtor's spouse in community property *as of the commencement* of the case" property of the Bankruptcy Estate, and *at the termination* of the Bankruptcy Estate, Section 726(c)(2)(A)-(D) provides that after payment of general and administrative expenses, the community property is segregated from other bankruptcy estate property into four subestates, claims are paid in accordance with (A)-(D), *and thereafter, an equal distribution results to each spouse or former spouse of what remains of the community property.*

Respondent raises three points in its opposition, none of which has any merit.

- Respondent argues for strict construction, which it consistently argued in the courts below. Respondent argues that because Susan is not a "debtor" she is not entitled to the § 1398(f) exclusion. Other sub-arguments from strict construction are that Susan did not receive her money from the bankruptcy estate, nor did she receive it at the termination of the estate. Respondent further suggests (Opp. p. 6, fn. 2) that the Fifth Circuit's decision involves a factually unique situation which does not affect others.

  Susan argues that the strict constructionist approach must be rejected because it results in arbitrary and patently unequal treatment of co-owners of community property. Susan refutes the suggestion that there are no other persons affected by the Fifth Circuit's decision. There are numerous, perhaps thousands of non-filing spouses who stand to receive distributions from their filing spouse's bankruptcy trustee and who will now be required to pay taxes on those distributions.
- Respondent argues that the "origin of the claim doctrine" should not be applied to the

Tenneco payment received by Susan. Every single reported case which has defined and then applied the "origin of the claim doctrine" mandates that the Tenneco payment to Susan be afforded the benefit of the IRC Section 1398(f)(2) tax exclusion. The doctrine is a *general one* and is not limited to the particular fact situations of previously reported cases. It is a singular doctrine which applies uniformly to both expenses/deductions taken, and to monies received.

- Susan refutes Respondent's position that she is not similarly situated because she is a "claimant" and not a "debtor". These differences are irrelevant and immaterial. Respondent is looking in the wrong place to find alleged dissimilarities. When considering the financially wounded non-filing spouse in community has involuntarily lost her community property interests under 11 U.S.C. § 541(a)(2), the pertinent and relevant *situation, context, and circumstance,* is not their respective status as "debtor" and "claimant" *within the bankruptcy proceeding*. **The relevant situation, circumstance and context, is their property ownership status as equal co-owners of the community property at the moment immediately preceding the commencement of the bankruptcy estate, as well as their co-equal entitlement to receive an equal distribution of what remains of the community property at the end of the bankruptcy estate under 11 U.S.C. § 726.**

The petition for writ of certiorari should be granted.

ARGUMENT

1. Respondent's strict construction ignores the substance of the transaction, inflicts a palpably arbitrary and patently unequal treatment upon one of two equal and identically situated co-owners of community property, and affects a significant number of community property owning spouses.

Conspicuous by its absence in Opposition Argument Number 1 is any reference to ***subsection (a)(2) of Bankruptcy Code Section 541 which operates to make the community property interests of the non-filing spouse property of the bankruptcy estate.*** This case deals exclusively with the community property of the non-filing spouse and the only focus should be on subsection (a)(2) of Bankruptcy Code Section 541. Any overlap between subsections (a)(1) and (a)(2) with regard to the debtor[1], is irrelevant because both operate in exactly the same manner, that is, both accomplish an absolute and total divestiture of all community property ownership interests of the debtor and the debtor's non-filing spouse, and vest those interests in the bankruptcy estate. There is no retention of any ownership interests by either the debtor or the debtor's non-filing spouse after all community property ownership interests vest in the bankruptcy estate.

The Fifth Circuit's decision damages all non-filing spouses in community property states. It is not as narrow a holding as Respondent argues. The Fifth Circuit's opinion is a case of first impression; the decision now provides case law precedent justifying IRS attempts to tax distributions received by the non-filing spouse under 11 U.S.C. § 726. The Fifth Circuit's opinion *clearly holds without qualification* that the non-filing spouse is not a "debtor". It is *not*

---

[1] 11 U.S.C. § 541(a)(1) would apply to all the debtor's separate property and the debtor's half of the community property, whereas subsection (a)(2) is more specific and applies to community property.

limited to the situation where a non-filing spouse sells his/her claim to a third party prior to a distribution. Presently there are numerous non-filing spouses who are waiting to receive distributions from their filing spouse's bankruptcy estates. In 1998 1.4 million Americans filed for personal bankruptcy, a nearly 95% jump since 1990.[2] Prior to the Fifth Circuit's decision, no reported case permitted attempts to collect taxes from a non-filing spouse on his/her 11 U.S.C. § 726 distribution. In the past such distributions probably went unreported and untaxed because the recipients and possibly the IRS viewed them as simply returns of what remained of one's own property and assumed that no taxes could possibly be owed. Unless this Honorable Court reverses the Fifth Circuit's decision, such reasonable assumptions are no longer true. Also, some peculiar, burdensome, and odd consequences follow: as the non-filing spouse is not considered a "debtor", then a burden to report a taxable transaction is imposed upon the non-filing spouse in the commencement year of the bankruptcy, arising from the involuntary exchange of the non-filing spouse's former interest in the community property for a claim against the filing spouse's bankruptcy estate. Whether or not any gain or loss is recognized has nothing to do with whether the transaction is classified as "taxable" or "nonrecognition".[3] Although the trustee is not before the court, the Fifth Circuit's decision also causes her

---

[2] *The Wall Street Journal*, May 6, 1999, "House approves bankruptcy overhaul amid criticism bill may be too tough." Section A, Page 28, 5th Paragraph. Schlessinger, Jacob M.

[3] 26 U.S.C. § 7701(45) defines a *nonrecognition transaction* as "any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A." **The receipt by the non-filing spouse of a claim to an eventual § 726 distribution is not anywhere defined by the IRS code as a nonrecognition transaction. Accordingly the transaction would have to be reported and any gain or loss thereon calculated, however difficult that task might prove to be.**

problems. The vesting in the bankruptcy estate of the non-filing spouse's half interest in the community property would have to be reported and gain or loss calculated (supra, at fn. 3), because the non-filing spouse is not a "debtor", and only transfers (no distinction is made between voluntary and involuntary) between the bankruptcy estate and the "debtor" are exempted from tax under IRC 1398(f).

2. The "origin of the claim doctrine" requires that the Tenneco payment to Susan be afforded the benefit of the IRC Section 1398(f)(2) tax exclusion.

Respondent argues that the "origin of claim doctrine" should only apply to monies received in settlement of a claim and not to sale proceeds received from a third party purchaser of the claim. This argument is not well founded and has no rational basis. Although most past cases involving the receipt of money did involve settlement of claims, the doctrine is not, nor should it be, restricted only to monies received in settlement of claims. Furthermore, the "settlement versus sale" distinction is unimportant. Every case involving the "origin of claim doctrine" decided by this Honorable Court and lower Federal Courts has followed a *general approach* in applying the doctrine. A purported distinction between a transaction that keeps the claim alive, and a payment which extinguishes or settles the claim is simply a *formalistic distinction* that has no merit in determining the tax consequences. (Pet. p. 15). Furthermore, past fact situations where the doctrine was applied do not limit its application to different facts which squarely fall within its concept and philosophy; ***it is the fundamental and underlying reality and substance of any transaction which determines the tax consequences***. The "origin of claim doctrine" has nothing to do with *who* paid the money, *why* a purchaser bought the claims, or *what* they subsequently did with the claims. This Honorable Court is asked to apply the doctrine to the monies Susan received. This case *does not* involve the tax classification of

the monies which Tenneco spent. Tenneco is not before this Court.

Respondent argues for a distinction between those cases where the "origin of the claim doctrine" was applied to expenses and deductions and those cases involving the receipt of monies. There should be no distinction whatsoever. The doctrine is singular and is to be uniformly applied to both situations. Respondent argues that *Lyeth v. Hoey*, 305 U.S. 188, 59 S. Ct. 155 (1938) is factually distinct from the instant case. The facts in *Lyeth v. Hoey*, supra, are certainly different, but conceptually the "origin of the claim doctrine" as enunciated in that case by this Honorable Court is identical. **Whatever may be the facts, the doctrine requires that the fundamental question, "for what was the money paid?" must always be answered. In Susan's case, the only thing that Susan could sell, and the only thing which could be purchased, was her claim against her husband's bankruptcy estate for a distribution under 11 U.S.C. § 726.**

Respondent admits that the bankruptcy trustee is *a separate legal and taxable entity* and is responsible for payment of all taxes relating to bankruptcy estate property. Respondent emphasized that the property of the bankruptcy estate includes all of the spouses' former community property. Curiously, Respondent (Opp. p. 9) retreats from its admissions by now claiming that the money Susan received from Tenneco should be treated, under the "origin of the claim doctrine", as if those monies had been received by her as an owner of the Gas Purchase Contract. Respondent avoids discussing the effect this argument would have on Ken and the trustee. One could argue Ken has to pay taxes on the proceeds the trustee received and further that the trustee is excused from paying taxes. Worse yet, both may be said to owe taxes. Obviously, Respondent's argument is meritless because *the "origin of the claim doctrine" cannot be applied beyond the point in time that Susan lost under Bankruptcy Code § 541(a)(2) her former equal ownership interest in the community property*. The claim for a Section 726 distribution received by operation of

Section 541(a)(2) is not an ownership interest in the Gas Purchase Contract nor an ownership interest in any other bankruptcy estate asset. *Susan and the trustee cannot own the entire interest in the same thing at the same moment in time.*

3. A failure to treat Susan as a debtor for purposes of conferring the benefit of the tax exclusion under IRC Section 1398(f)(2) denies her equal protection of the laws as guaranteed by the Fifth and Fourteenth Amendments of the United States Constitution. When considering the situation, circumstance and factual context of the non-filing spouse in community, the claimed distinctions of "debtor" and "creditor" are not relevant and are not material.

When a denial of equal protection question arises, the **first step** is to identify and define the circumstance, context or situation within which the denial occurs. In some circumstances and situations a group of individuals may share little or no similarities, whereas in other contexts, circumstances and situations, members of the group may share identical characteristics. Put another way, *the relevant situation, context and circumstance* (hereinafter, "right place") must be initially determined.

The **second step** is to examine the claims of similarities and/or differences to determine if they exist within the right place. Any so-called differences described by Respondent must be examined to see if they fall outside of the right place. If the cited differences are indeed *outside of any relevant situation, context, and circumstance* (hereinafter, "wrong place"), those differences are immaterial and irrelevant.

The differences cited by Respondent are the result of looking in the wrong place. When considering the denial of equal protection to the non-filing spouse who has lost involuntarily and by operation of law his/her entire interest in the community property, the wrong place to look is *within the bankruptcy proceeding. It is only the bankruptcy proceeding that reclassifies the two community property owners as "debtor" and "claimant".*

The right place to look is the spouses' property ownership status as equal co-owners of the community property at the moment *immediately preceding* the commencement of the bankruptcy estate, and the right of each to receive an equal distribution of what remains of the community property *at the end* of the bankruptcy estate. 11 U.S.C. § 726. As stated in petitioner's application, there are nine community property states, and Louisiana is one of them (Pet. p. 3). Louisiana Civil Code Article 2336 establishes the fundamental rule of Louisiana Community Property:

> "Each spouse owns a present undivided one-half interest in the community property. . . . "

Immediately preceding the commencement of the bankruptcy estate Susan and Ken owned a *"present undivided one-half interest in the community property"*. After the moment of filing but prior to the time of a final distribution, all of the former community property belonged to the bankruptcy estate. (11 U.S.C. § 541(a)(2)). There is absolutely no difference between the spouses in community immediately prior to the filing of the bankruptcy, and there is no difference between them with respect to the manner that Section 541(a)(2) deprives each of them of their half interests in the community property. Ken and Susan are identically situated.

Each perceived difference between the spouses described by Respondent is the result of looking in the wrong place. *What happens to both within the bankruptcy is not the relevant factual situation, context, or circumstance.*[4] If Respondent would search in the right place, it would be at a loss to find any differences at all.

An equal protection analysis under the due process clause of the Fifth Amendment requires a showing that the class discriminated against suffers from a significant deprivation of a benefit or the imposition of a substantial

---

[4] Irrelevancies include: ability to file a proof of claim, a preferential purchase right, and the status of "debtor" versus "claimant".

burden. *Califano v. Boles*, 443 U.S. 282, 295, 99 S. Ct. 2767, 2775 (1979). The equal protection clause of the Fourteenth Amendment is an additive to the protection guaranteed by the Fifth Amendment. *Hampton v. Mow Sun Wong*, 426 U.S. 88, 100, 96 S. Ct. 1895, 1904 (1976). Susan is a member of that class of persons most appropriately defined as **non-filing spouses who lose their undivided half interest in community property to the bankruptcy estate of their filing spouse by operation of 11 U.S.C. § 541(a)(2).** This class suffers a significant deprivation of a benefit, that is the tax exclusion afforded to the filing spouse by 26 U.S.C. § 1398 (f)(2). This class is identically situated in all respects to the debtor (filing spouse) as to their ownership interest in the community property and with respect to their right to receive an equal distribution of what remains of their community property at the end of the bankruptcy estate. There is no reason why one spouse should be afforded the benefit of a tax exclusion and the other denied that benefit. Respondent has not asserted that this denial of equal protection is somehow justified by some compelling or overriding national interests. It is apparent that there could not possibly be any rational justification for treating community property owning spouses differently by exempting one from tax and not the other upon the return of what remains of their own property.

CONCLUSION

There is a grim irony present in this case. Ken initiated a proceeding under Chapter 7 and listed almost nothing on his bankruptcy schedules, concealing an asset worth many millions of dollars. Susan refused his requests to join in the filing of his fraudulent Petition. Susan provided key and pivotal evidence which resulted in the trustee successfully obtaining a judgment in the bankruptcy court holding the Gas Purchase Contract to be community property and property of the bankruptcy estate. (Pet. p. 4). The trustee later settled Tenneco's liability for millions. When Ken received his distribution, he was afforded the benefit

of the Section 1398(f)(2) tax exclusion, however, after Susan sold her claim for the identical distribution, she was required by Respondent to pay a tax on the sale proceeds. She is being deprived of a substantial benefit because she decided to extricate herself from the bankruptcy morass into which she was involuntarily tossed by the filing of a fraudulent petition by her estranged husband.[5]

The Fifth Circuit's decision has a much broader application than Respondent would like this Court to believe. It is the first decision of its kind which holds that the non-filing spouse in community, regardless of whether she sells her claim or retains it, is *not a debtor* and therefore is not entitled to the benefit of the tax exclusion under 26 U.S.C. § 1398(f)(2).

Susan's petition for a writ of certiorari should be granted.

Dated: June 1, 1999

Respectfully submitted,

R. Lee Eddy, III*
433 Metairie Road, Suite 100
Metairie, Louisiana 70005
(504) 835-0378

Frank J. Romaguera IV
Suite 1130
3850 North Causeway Boulevard
Metairie, Louisiana 70002
(504) 830-2929

Counsel for Petitioner

**Counsel of Record*

---

[5] Memorandum Opinion of Hon. T.M. Brahney, III, dated August 19, 1993 in *Marrero versus Bordelon, et als.*, Adversary 92-1036 (Bankr. E.D. La. 1993) at 18 and 22-23.